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Harmonizing the Policy of the Bankruptcy Code and Article 9

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Harmonizing the Policy of the Bankruptcy Code and Article 9

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In a true sense bankruptcy law--at least as represented by the 1978 Code--is in conflict, not in harmony, with Article 9. To a considerable degree (perhaps more than they realize) debtors and unsecured creditors got things they wanted from Congress by the adoption of the Bankruptcy Reform Act of 1978. It is doubtful that that Act could have been passed in any Congress before or since. In many ways, the rights of the debtor and of the unsecured creditors have been cut back since the adoption of the Bankruptcy Reform Act.

Consider the points of dispute discussed below and some of the things that might be done about them.

1. Virtually all of the litigation on the question whether a security interest has been perfected arises in the bankruptcy court. There one sees bankruptcy judges dealing with the question whether name changes, the omission of a name, or some other defect in the place of filing or in the document that was filed renders a secured creditor unperfected. Most of that litigation would go away if 9-301(1)(b) were repealed. That section reads as follows:

Except as otherwise provided in subsection (2), an unperfected security interest is subordinate to the rights of (b) a person who becomes a lien creditor before the security interest is perfected[.]

If section 9-301(1)(b) were repealed, an unperfected security interest would defeat a lien creditor under state law. Since the trustee in bankruptcy has the rights of a lien creditor--and

normally no greater rights--against a personal property secured creditor, the trustee's claims under 544(a) would be subordinated to the unperfected secured creditor's claim and he would lose to the secured creditor even in circumstances where the secured creditor had failed to file a financing statement.

Why have not the secured creditors proposed the abolition of 9-301(1)(b) or, a smaller step, the addition of a term to Article 9 to the effect that any good faith attempt at filing renders the secured creditor perfected at least against a lien creditor? One might argue for this outcome in bankruptcy on the theory that the trustee represents basically unsecured creditors, most of whom will never have been injured by or relied upon an absence of filing by a secured creditor. See, James J. White, "Revising Article 9 to Reduce Wasteful Litigation," 26 Loy. L.A.L.Rev. 823 (1993).

2. A second grand area of conflict between bankruptcy and Article 9 arises in attacks on secured lenders who finance LBOs. In a number of cases the creditors' argument that they give reasonable equivalent value by lending money has fallen on deaf ears. Collapsing these transactions, courts have been willing to say the secured creditor's loan goes into the hands and pockets of the shareholders of the target company (even though the money is not lent directly to them) whereas the value comes out of the pocket of the target company itself. Thus the value is given to one and the transfer comes from another. This outcome, of course, makes the secured creditors into the policemen of the LBO

trade. But where do the courts get the power to disregard the form of the transactions? Should the Bankruptcy Code or, more likely the state fraudulent conveyance law, be modified to recognize that the secured creditor gives new value and is not therefore subject to upset by a fraudulent conveyance argument?

3. The most pervasive point of tension between secured creditors on the one hand and bankruptcy on the other arises from the stay, from the terms of section 1129 and from other sections in Chapter 11 that allow the debtor in possession to disregard the supposed superiority and full protection that the Bankruptcy Code gives to the secured creditor.

What could and should be done with the Code here? Would a shortening of the exclusivity period be sensible? What about the possibility of the Code's adopting the losing proposition in Timbers, namely, that adequate protection always includes the requirement of paying current lost opportunity costs to a secured creditor who will not receive its collateral at once? Are the secured creditors going to argue for such changes before the Commission and the Congress? What other suggestions should they go for?